

Message Text

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C O N F I D E N T I A L SECTION 1 OF 2 BUENOS AIRES 2759

DEPARTMENT PASS TREASURY & COMMERCE

GENEVA FOR MTN DEL

E.O. 11652: GDS

TAGS: EGEN, EFIN, AR

SUBJECT: CURRENT ECONOMIC SITUATION AND PROSPECTS

1. SUMMARY: ARGENTINE ECONOMIC SITUATION VIEWED AS SERIOUS, PROBABLY BECOMING MORE SO IN SECOND HALF YEAR. MAJOR FEATURES OF CURRENT SCENE INCLUDE ACCELERATED INFLATION, MIXED OUTPUT, CONTINUED SUPPLY SHORTAGES, WORSENING LABOR PROBLEMS, AND TIGHTER PRIVATE CREDIT AND BALANCE OF PAYMENTS POSITION. SOME US COMPANIES ESPECIALLY HARD-HIT BY LABOR DIFFICULTIES, IN ADDITION OTHER PROBLEMS WELL KNOWN WASHINGTON. POLITICAL WEAKNESSES IN GOVERNMENT PREVENTING GOA FROM ENACTING MEAN-
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INGFUL ECONOMIC REFORM, AND ADVERSE STATE OF ECONOMY NOW HURTING

GOA POLITICALLY. IF CURRENT TRENDS CONTINUE, BELIEVE ARGENTINA LIKELY SLIDE INTO ECONOMIC DOWNTURN ACCOMPANIED BY RECORD INFLATION LEVELS, AND MORE DIFFICULT EXTERNAL SITUATION. ON OTHER HAND, WE BELIEVE 1975 COULD STILL BE RELATIVELY FAVORABLE YEAR ECONOMICALLY IF THIS, OR ANOTHER, GOVERNMENT PREPARED INTRODUCE MEANINGFUL ECONOMIC REFORM END SUMMARY.

2. CURRENT SITUATION - INFLATION IS MOST IMMEDIATE AND PRESSING PROBLEM FACING GOA. COL INDEX UP 7.6 PERCENT FOR JANUARY- FEBRUARY AND LIKELY SHOW MORE THAN 60 PERCENT INCREASE FOR YEAR. GOA DOES NOT YET HAVE WAGE-PRICE SPIRAL UNDER CONTROL, WHICH CAUSING INCREASING PUBLIC ANXIETY. PRESSURES COMING FROM BOTH DEMAND-SUPPLY DISEQUILIBRIUM AND COST PUSH. CONDITIONS OF PRIVATE INDUSTRY, IF ANYTHING, ARE WORSE THAN IN 1974. SOME COMPANIES ARE BETTER OFF PRICE WISE, BUT NEW FREEZE INTRODUCED LATE FEBRUARY IS HURTING. MOST FIRMS CONTINUE TO HAVE DIFFICULTY OBTAINING RAW AND INTERMEDIATE MATERIAL INPUTS, AND SHORTAGES OF CONSUMER GOODS HAVE INCREASED. MOREOVER, LABOR PROBLEMS ARE BECOMING MORE SERIOUS-INCLUDING ABSENTEEISM AND STRIKES. ALL OF THESE FACTORS HAVE ADVERSELY AFFECTED INDUSTRIAL OUTPUT DURING FIRST QUARTER 1975. SOME US COMPANIES HAVE BEEN ESPECIALLY HARD-HIT BY LABOR DIFFICULTIES AND GOA RESTRICTIONS ON DOMESTIC CREDIT WHICH DISCRIMINATE AGAINST FOREIGN FIRMS. DIFFICULTIES AND COMPLAINTS OF US FIRMS SYMPTOMATIC OF GOA FOREIGN INVESTMENT POLICY WHICH HAS TOTALLY FAILED ATTRACT NEW INVESTMENT. HEAD OF US CHAMBER HAS TOLD US HE HAS NEVER SEEN INEFFICIENCY AND CORRUPTION WORSE IN ARGENTINA. WITH EXCESS DOMESTIC DEMAND, UNREALISTIC EXCHANGE RATES, WEAKENING OUTPUT, AND HEAVY EXTERNAL DEBT OBLIGATIONS, BALANCE OF PAYMENTS CONDITIONS BECOMING MORE DIFFICULT. IN FACT, IT IS UNUSUAL THAT EXTERNAL SITUATION HAS REMAINED SO STRONG FOR SO LONG. ACCORDING GOA, IMPORTS DURING LAST SIX MONTHS HAVE SURGED, WHILE FIRST QUARTER EXPORTS BELOW ESTIMATED LEVELS. (ECONOMY MINISTER HAS JUST ESTIMATED EXPORTS AT \$3,700 MILLION FOR YEAR WITH \$300-\$400 MILLION TRADE SURPLUS.) CONSEQUENT DETERIORATION

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TRADE BALANCE IMPORTANT FACTOR CAUSING GOA TO FINALLY UNDERTAKE RECENT DEVALUATION AND TIGHTEN UP ON EXCHANGE AND IMPORT CONTROLS. ALL OF ABOVE PROBLEMS HAVE CONTRIBUTED TO CLIMATE OF PESSIMISM REGARDING ECONOMY AND GOA CAPACITY TO HANDLE SITUATION.

3. BACKGROUND - IN OUR VIEW, CURRENT SITUATION INEVITABLE RESULT TWO YEARS PERONIST EXCESS SPENDING PROGRAMS AND POOR

ECONOMIC MANAGEMENT. GOA HAS FOCUSED ON INCOME REDISTRIBUTION, USING WAGE-PRICE POLICY AS PRIMARY INSTRUMENT TO ACHIEVE ITS OBJECTIVE. WITH PRICES TIGHTLY CONTROLLED, NOMINAL WAGES HAVE BEEN INCREASED REPEATEDLY IN FACE DECLINING PRODUCTIVITY. INEVITABLE RESULT HAS BEEN REDUCTION IN OVERALL CORPORATE PROFITABILITY, SEVERELY DISTORTED PRODUCTION, AND LACK OF INVESTMENT INCENTIVE. MONETARY AND FISCAL POLICIES ALSO HAVE BEEN SUBORDINATED TO INCOME REDISTRIBUTION OBJECTIVES INSTEAD OF BEING USED TO CONTROL AGGREGATE DEMAND. THUS FISCAL DEFICIT ALLOWED TO RISE SHARPLY, CONTRIBUTING TO EXCESS MONETARY EXPANSION AND DEMAND-SUPPLY DISEQUILIBRIUM. IN PRACTISE, GOA STRATEGY HAS NOT EVEN ACHIEVED DESIRED INCOME REDISTRIBUTION OBJECTIVES. MAJOR INCOME SHIFTS HAVE NOT BEEN FROM RICH TO POOR, BUT FROM THOSE WHO ABIDE BY GOA CONTROLS TO THOSE WHO ESCAPE THEM. RESULT HAS BEEN EXPANDED BLACK MARKET AND INCREASED SPECULATIVE INVESTMENT IN NON-PRODUCTIVE ACTIVITY. MANY OBSERVERS FELT GOMEZ MORALES, WHEN HE BECAME ECONOMY MINISTER, WOULD GET ECONOMY STRAIGHTENED OUT AND HE HAS, IN FACT, INTRODUCED MANY POSITIVE CHANGES (DEVALUATION, PRICE LIBERALIZATION, PUBLIC SECTOR TARIFF RATE INCREASES, POSSIBLE LIBERALIZATION OF FOREIGN INVESTMENT REGULATIONS, SOME DECONTROL OF ECONOMY, ETC.) HOWEVER, THESE CHANGES FALL SHORT OF MORE FUNDAMENTAL REFORMS NECESSARY AS IS INCREASINGLY OBVIOUS TO EVERYONE. IN PRACTISE, PRESENT POLITICAL INSTABILITY AND POWER BALANCE MAKES IT EXTREMELY DIFFICULT FOR ECONOMY MINISTER TO INTRODUCE SUCH REFORMS. ECONOMIC POWER NOW MORE OR LESS SHARED (AND FOUGHT OVER) BETWEEN GOMEZ MORALES AND ECONOMIC TEAM, LOPEZ REGA, (WHO CONTROLS ACCESS TO PRESIDENT AND SIGNIFICANT POWER OF SOCIAL WELFARE MINISTRY) AND CGT LABOR UNIONS (PRESSING AGGRESSIVELY FOR LARGER POLITICAL

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ROLE AND INCREASED REAL INCOME). THESE POWER CENTERS ALL HAVE DIFFERENT INTERESTS, AND OBJECTIVES, AND RESULT THUS FAR HAS BEEN MORE OR LESS STALEMATE.

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4. PROSPECTS- IN OUR VIEW, MOST LIKELY PROSPECT IS FURTHER DETERIORATION OF ECONOMIC SITUATION THIS YEAR. GDP GROWTH NOT LIKELY EXCEED 5 PERCENT (WHICH STILL QUITE GOOD BY WORLD STANDARDS) WITH DYNAMIC ELEMENTS REMAINING CONSUMPTION AND CONSTRUCTION. PUBLIC SECTOR INVESTMENT WILL BE HURT BY INTERNAL AND EXTERNAL FINANCIAL RESTRAINTS, WHILE ANTICIPATED UPSURGE IN PRIVATE PRODUCTIVE EQUIPMENT INVESTMENT LESS LIKELY MATERIALIZE. WAGE-PRICE SPIRAL WILL CONTINUE LEADING TO INCREASED SOCIAL AND POLITICAL DISCONTENT. PRIVATE SECTOR PROBLEMS WILL REMAIN SERIOUS WITH OUTPUT INCREASINGLY WEAKENED BY ADVERSE LABOR AND SUPPLY SITUATION. SITUATION OF US COMPANIES LIKELY TO REMAIN ESPECIALLY DIFFICULT. AGRICULTURE, AS IN PAST TWO YEARS, SHOULD REMAIN RELATIVELY STRONG DESPITE RECENT FLOODS. TO COPE WITH BALANCE OF PAYMENTS PRESSURES, GOA LIKELY TO TIGHTEN IMPORT AND EXCHANGE CONTROLS FURTHER
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DURING YEAR, WHILE CONTINUING TO SEEK SUBSTANTIAL EXTERNAL FINANCING. IF SUFFICIENT CAPITAL INFLOWS AVAILABLE, ARGENTINA SHOULD BE ABLE TO GET THROUGH YEAR WITH RELATIVELY SMALL GROSS EXTERNAL RESERVE LOSSES. FURTHER DEVALUATION OF FINANCIAL RATE QUITE POSSIBLE TOWARD YEAR END. WHILE ABOVE CONSTITUTES MOST LIKELY SCENARIO,

THERE IS STILL OUTSIDE CHANCE THAT THIS GOVERNMENT, OR SOME OTHER, WILL INITIATE ECONOMIC REFORMS NECESSARY TO REDUCE DISTORTIONS AND PUT ECONOMY ON STABLE GROWTH PATH. IN OUR VIEW, ANY REFORM PROGRAM WOULD HAVE TO INCLUDE, AT MINIMUM (1) MEASURES TO REDUCE AGGREGATE DEMAND, IN PARTICULAR A REDUCTION OF FISCAL DEFICIT; (2) MAJOR INCREASES IN PRODUCTIVITY TO RAISE OUTPUT-COMBINED WITH WAGE RESTRAINT; (3) LONGER TERM MEASURES TO RAISE SAVINGS AND INVESTMENT INCLUDING POSITIVE REAL INTEREST RATES TO STIMULATE SAVINGS AND REDUCE CONSUMPTION AND (4) FLEXIBLE AND REALISTIC EXCHANGE RATES TO IMPROVE TRADE BALANCE AND STIMULATE CAPITAL INFLOWS. THERE PROBABLY WOULD BE SURPRISINGLY WIDESPREAD CONSENSUS IN ARGENTINA ON NEED FOR PROGRAM ALONG THESE LINES, BUT IMPLEMENTATION OF SPECIFIC MEASURES WILL REQUIRE STRONG POLITICAL SUPPORT.
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